

The long game

April 30 OCR Preview: RBNZ expected to cut 50bps to 2.50%

- **The economic outlook has worsened since the March Monetary Policy Statement. Global growth forecasts continue to fall, and financial conditions in New Zealand have tightened when the RBNZ expected them to ease.**
- **There is a strong economic case for a 50bp cut next week, but other considerations make it a close call between 25bp and 50bp.**
- **We think the RBNZ will need to strengthen its commitment to keeping interest rates low for an extended period, in order to keep long-term rates under control.**

In the 12 March *Monetary Policy Statement*, the RBNZ noted that the outlook for the economy was highly uncertain, with the risks around their projections largely to the downside. Those downside risks are becoming reality, making it likely that the RBNZ will need to cut the OCR further than they assumed. We think there is a strong economic case for a 50bp cut at next week's review, but tactical considerations could make it a much closer call between 25bp and 50bp. Perhaps more importantly, though, the experience of recent weeks shows that the RBNZ will have to think carefully about the influence they have over long-term interest rates – especially if they believe that they are nearing the limits of what they can do with the OCR itself.

The main negative developments since March are:

The exchange rate is higher than assumed. In March the RBNZ cut the OCR by 50bp, less than the market expected, and indicated that any further cuts are likely to be smaller than those seen recently. What was glossed over, though, was that their relatively optimistic economic forecasts still required a much easier mix of financial conditions – which they assumed would come about largely through a weaker exchange rate. Instead, the NZ dollar has actually risen, and is currently tracking about 10% above the RBNZ's projections. If the currency won't co-operate, the burden of easing falls back onto interest rates.

Long-term interest rates have risen. As far as the RBNZ's problems go, this one was largely self-inflicted – their smaller-

than-expected rate cut and weak easing bias in March pushed market interest rates higher, which borrowers read as a signal that rates were past the bottom of the cycle. The subsequent wave of demand to lock in fixed-term rates at what were historically low levels, combined with a lack of liquidity in the market, saw long-term swap rates rise by more than 100bp at their peak.

This was of such concern to the RBNZ that on 1 April they issued a statement that “the rise in longer-term interest rates is unwarranted and inconsistent with the monetary policy outlook” – the first time in over ten years that they have given explicit guidance to the market between OCR review dates, and a clear indication that things aren't going to plan. Long-term rates have eased back a little since then, as the demand to fix has waned, but the RBNZ is likely to treat some of the rise in rates as permanent.

The world growth outlook is weaker. The latest Consensus Forecasts for growth in our major trading partners were revised down to -2.2% for this year, compared to the RBNZ's forecast of -1.8% in the March *MPS* (and -0.9% for Consensus at the time). Importantly, the RBNZ has made a point of keeping their world growth forecasts at a margin below Consensus in recent months, reflecting a greater degree of concern about the slowdown in the Asia-Pacific region, and the collapse in international trade in particular. Consensus forecasts for 2.0% growth in 2010 have yet to meet the RBNZ's gloomier pick of 1.6%, but in practice forecasters rarely make large revisions to their next-year forecasts until closer to the date.

The starting point for the NZ economy is weaker. GDP fell by 0.9% in Q4 2008, against the RBNZ's forecast of a 0.8% decline, and Q3 was revised down a tick. In addition, we think the RBNZ will have revised their forecast for Q1 2009 from -0.8% to -1.0%, giving a combined 'surprise' of -0.4%. The latest *Quarterly Survey of Business Opinion* reinforced the sense that Q1 was at least as difficult as Q4 – indeed, without the contributions of agriculture and government (which are not covered by the *QSBO*), GDP in the last two quarters could have been on a par with some of the horrific outturns seen overseas.

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On a more positive note, net inward migration has picked up markedly in recent months, with fewer New Zealanders heading overseas as job prospects in Australia and the UK deteriorate. The RBNZ's last projection was for a net inflow of 5,700 this year, but with the annual pace already running at 7,500, they may revise their forecasts to as much as 15,000. This will have significant implications for their views on housing, employment and consumer spending. Activity in the housing market has also noticeably picked up in recent months, though it has taken record-low interest rates to achieve even a modest rebound. And world prices for milk powder exports have bounced from their lows, though nowhere near enough to justify the recent gains in the NZ dollar.

A close call for 50bp

On balance, the economic picture is weaker than assumed in the March *MPS*, which points to lower interest rates for longer – we expect the trough in the OCR to be more like the RBNZ's 'alternative' of 2.0% than their central view of 2.5%. This leaves room for a rate cut of as much as 50bp next week, which we see as the most likely option – but only just. There are a number of unquantifiable factors that could be used to justify a 25bp cut.

First, the RBNZ believe that there are consequences in taking the OCR to very low levels. The March press release noted that "New Zealand needs to retain competitiveness in the international capital markets", implying that rates among New Zealand's peers (specifically Australia) may be a constraint on policy settings here. As we have noted before, this is simply not an issue for decisions about the overnight cash rate – if overseas investors demand a premium for lending to New Zealand, then longer-term market rates (and possibly the exchange rate) will factor one in. But with the NZ and Australian cash rates both at 3%, we worry that the RBNZ will be reluctant to stray much further than 25bp from the RBA right now.

And if the lower bound for the cash rate really is more like 2% as the RBNZ suggests, rather than zero, then it seems that they have very little firepower left. The temptation will be to hold back some of the easing until later this year, giving them room to respond to weaker economic data as it arrives. It's questionable whether delaying rate cuts in this manner actually helps the economy – as opposed to giving the appearance of helping – but we expect it to feature as part of the debate nonetheless.

Finally, sentiment in global financial markets has noticeably improved in recent weeks, and while sentiment is a fickle thing, it may give the RBNZ comfort that they don't need to deliver a large rate cut to soothe markets this time.

Lower for longer

What may prove to be even more important in next week's statement is the message that the RBNZ sends about the duration of this easing cycle. It's widely recognised that central banks have little direct control over long-term interest rates. But they can have a strong indirect influence, by clearly signalling

their future policy intentions to the market. And the RBNZ are especially well-placed to do this, as they publish an explicit projection for 90-day rates in every quarterly *MPS*.

So what did the March *MPS* signal to the market? That 90-day rates were unlikely to go much lower, and that rate hikes were expected to begin by mid-2010. Right off the bat, this meant that longer-term market rates at the time were lower than what was consistent with the RBNZ's projections – which, not surprisingly, kicked off the sharp rise in long-term rates in March.

The RBNZ's rate projections are an important part of their forecasting process, but the risk is that they can be counterproductive as a signalling tool. Around the world, central banks are focused on providing further stimulus, with many of them resorting to quantitative easing now that they have run up against the zero-bound for interest rates. Is anyone really in a position to be talking about the timing and extent of the next tightening cycle?

Markets will naturally try to anticipate the next big upward move in interest rates – they need no encouragement from the central bank, and at worst they could end up undoing much of the RBNZ's good work. For the RBNZ to keep a lid on long-term rates, we think they will have to use much stronger language on the policy outlook than they did in the March *MPS* – merely repeating that the OCR will "remain at relatively low levels for an extended period", as they did in the April 1 statement, probably won't cut it.

Market implications

Interest rate markets are about evenly split between a 25bp and a 50bp cut next week. A 25bp cut would disappoint the market and push swap rates higher, though the reaction is unlikely to be as violent as it was after the March review – rates seem to have risen far enough to turn borrowers off from fixing for long terms. A 50bp cut would encourage a further unwinding of the sharp rise in long-term rates since March. But as we have noted, the strength of the RBNZ's commitment to keeping rates lower for longer may be the more important factor in how the market responds.

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